

November 1, 2000

Ms. Janet McCabe
Assistant Commissioner
Office of Air Management
Indiana Department of Environmental Management
100 North Senate Avenue
P.O. Box 6015
Indianapolis, IN 46206-6015

Re: Development of Nitrogen Oxides Budget Trading Program – 326 IAC 10-4

Dear Ms. McCabe:

State Line Energy, LLC appreciates this opportunity to submit comments on the proposed Nitrogen Oxides Budget Trading Program, developed in response to the U.S. EPA's NO_x SIP call and to be codified at 326 IAC 10-4. We also offer to meet with your staff to further clarify these comments if the Agency so desires. Our comments focus primarily on the practical concerns that we believe will significantly affect the implementation of the SIP call.

I. Trading

State Line Energy appreciates the steps the IDEM has taken to develop a viable NO_x trading program to help minimize compliance costs for affected sources within the State. We agree with IDEM that this program can be developed by adopting EPA's model NO_x trading rule, but we recommend targeted changes to enhance the viability of the program. Moreover, we believe that implementing a cap and trade program will be beneficial from an agency resource standpoint in that it will take far fewer State resources to implement the NO_x trading program than it would take to implement a command and control program imposing equivalent emissions reductions.

Allowance Allocation Methodology. State Line Energy supports several key positions related to an allowance allocation methodology for electricity generating units: (1) allowance allocations should *not* be made on the basis of a single historical year's data; (2) the initial allowance allocations should be based on heat input; and (3) allowance allocations should be fixed for no more than two years.

Data for Allocating Allowances. Under the October 1998 NO_x SIP call, NO_x allowances would be allocated based on the average of the highest two years of heat input between 1995 and 1997, multiplied by 0.15 lb/mmBtu (and adjusted, as appropriate, to ensure that the budget established by EPA is not exceeded). IDEM's proposed rule incorporates this approach, although the IDEM has stated its willingness to modify this methodology to allow sources to take the average of the highest two years of heat input data between 1995 and 1999. State Line Energy supports this approach and, indeed, believes that IDEM should also expand this period to allow sources to include their 2000 ozone control period heat input. Such an approach ensures that all sources within the State are on relatively equal ground in terms of being able to choose which of the past six years are most representative of normal operations for purposes of allocating

allowances. Moreover, there is no environmental disbenefit to this approach, as the overall emissions from the electricity generating sector remain capped at the same level no matter what heat input values are used for individual sources.

More generally, we agree that with the possible exception of newly-operating sources as discussed below, it is never appropriate to allocate allowances based on a single year's past operating experience. There are too many variables, such as unforeseen forced outages, which can result in a unit having non-representative low heat input for any given year. If this low heat input then determines the unit's allowance allocation in subsequent years, the unit could be unfairly penalized. Instead, we believe that for each allocation period, a unit should be able to use the average of its highest two-year's heat input during a prior five year period to determine its allowance allocation for the subsequent allocation period.¹

For new units which have begun operating and have two or less full ozone control periods of heat input data at the time allowances are allocated, State Line Energy recommends that the source be given the option either of taking its single highest ozone control period's heat input or, in the alternative, of remaining within the new source set-aside for the subsequent allocation period. Such an approach addresses the concern that in the initial year or two of operation, a new source may not have reached its full operating capacity (perhaps because it did not begin operation until the middle of the ozone control period, or because it has not yet reached optimum operating conditions or what ultimately will be its appropriate place in the dispatch order). Yet if a source were allocated allowances for subsequent years based on that non-representative low heat input, it could be penalized for several years to come.²

Heat Input Versus Electricity Output. State Line Energy does not support a NO_x allowance allocation methodology based on electricity output.

New Source Set-aside. EPA's model rule included a recommended new source set-aside. It would allocate new source allowances on a first-come, first-served basis, with any unused allowances being returned to existing sources on a pro rata basis. The Agency has stated its belief that new sources, because they are more clean-burning, should receive allocations on the same basis as that used for existing units until the time when the new sources receive an allocation as part of an updating allocation system. EPA recommends that States set-aside five percent of their allowances for 2003-2005 to cover new source emissions with a two percent set-aside for subsequent years.³ Consistent with EPA's recommendation, IDEM has proposed a five percent new source set-aside in the first allocation period, with a two percent set-aside in subsequent allocation periods. IDEM also proposes to allocate allowances on a first-come, first-served basis, with any unused allowances being returned to existing sources on a pro rata basis.

State Line Energy agrees with the IDEM in their proposed rulemaking regarding the new source set-aside issue. We also recommend some important clarifications to the rule which we believe will increase certainty and enhance the viability of the new source set-aside.

1 For example, if IDEM plans to allocate allowances for the 2010 – 2011 control periods, the allocations must be made by 2007 (three years in advance), and thus would be based on the average of the highest two heat inputs for the 2002-2006 ozone periods.

2 Indeed, if allowances are not readily available on the market, the source could be forced to continue operating at a lower level than is economically appropriate simply because its artificially low initial allocation forces the source to restrict its operations to avoid exceeding its NO_x budget.

3 EPA emphasizes, however, that States may address new sources in any way that they choose so long as emissions from those new sources are subject to the overall State budget.

First, State Line Energy recommends that new source set-aside allowances be allocated on a first-come, first-served basis, *based on the date the source is issued an approved construction permit*. We believe that this approach minimizes uncertainty for sources and also is the most fair, as those sources who get permits first likely have made the earliest initial investments and therefore should be first in line to receive allowances from the new source set-aside. Of course, if for some reason construction and ultimate operation is delayed at such a source until past the ozone control period, then the allowances that would have been allocated to the source to cover its NO_x emissions would go to the subsequent new sources.

Second, we agree that because new sources are allocated allowances based on their maximum heat input (times the lower of 0.15 lb/mmBtu or their permitted emission rate), they should be required to return any unused allowances at the end of the ozone control period. However, because these units may command a portion of the new source set-aside that is significantly higher than what they actually need to operate (as such a source is unlikely to approach 100% capacity, particularly in the first few years of operation), there likely will be other new sources lower in line that do not receive any guarantee of allowances from the set-aside. We believe that before “unused” allowances are returned to existing sources pro rata, those allowances should be allocated to any new sources that were too low in line to receive a guarantee of allowances from the set-aside. Such an approach more accurately reflects the purpose of the set-aside (*i.e.*, to ensure that new sources have sufficient allowances to operate until such a time as they can be fully integrated into the allowance program). As a practical matter, it may be necessary to require new sources that initially receive allowances from the set-aside to have an expedited “true up” period so that the lower in line new sources will know whether they will receive any allowances from the set-aside before the allowance surrender deadline.

II. Energy Efficiency and Renewable Energy Set-Aside in the NO_x Budget Trading Program

The U.S. EPA has issued guidance advocating that States withhold NO_x emission allowances from affected EGUs subject to the NO_x SIP call to give to persons who implement approved energy efficiency or renewable energy projects as an incentive to implement such projects. The IDEM has requested comments on whether such a set-aside should be included within the NO_x Budget Trading Program.

State Line Energy opposes inclusion of such a set-aside in the Indiana response to EPA’s SIP call. As an initial matter, it should be noted that the adoption of the set-aside would not improve the air quality, and is not mandated as a part of the NO_x SIP call. As a result, the imposition of a set-aside on the electric generating units within a State would represent a restraint more stringent than the already extremely stringent emissions reduction requirements of the SIP call.

Unless there is certainty that at least the same number of allowances will be returned to the trading system as were withheld in a given year, use of such a set-aside represents a net decrease in the overall trading budget which will create a still more stringent emission limit. Coupled with the new source set-asides which have been proposed, the emissions cap will effectively be up to 20% more stringent, equating to an effective emissions limit of approximately 0.12 lb/mmBtu times the baseline heat input. Creation of an energy efficiency reserve will therefore require installation of additional controls, raise the EGUs compliance costs, and further reduce the benefits of allowance trading.

EPA claims that the renewables set-aside is a mechanism that will reduce the overall cost of compliance with the very stringent NO_x SIP call budgets. However, EPA’s guidance overstates the benefits and understates the costs of such a program. In addition, it introduces an unacceptable level of uncertainty to

compliance planning which will result in less cost-effective over-compliance by EGUs. As a result, the effect of such a reserve will be to increase the overall cost to EGUs and the economy with little or no commensurate environmental benefits.

EPA is encouraging State environmental agencies to go beyond their mandate by setting energy policy without the participation of utility regulatory commissions and other agencies charged with establishing and implementing energy policy within a State. Its analysis fails to take into consideration a broader range of issues, and seems to rely solely on the assertion that conservation and renewables are always better than fossil generation regardless of cost. This assumed preeminence of conservation and renewables oversimplifies the broad range of factors that should be considered in adopting energy policies.

Thus, State Line Energy believes that Indiana should not adopt energy efficiency/renewable energy incentives as a part of the NO_x SIP call for the following reasons: (1) setting allowances aside for energy efficiency and renewable energy projects will increase uncertainty and raise electricity generator compliance costs; (2) the approach advocated by EPA would seek to continue mandatory utility-funded demand side management programs and impose an unfair, indirect tax on customers; (3) the treatment of “free riders” ensures windfalls to projects that will be implemented anyway because of their overall cost-effectiveness, but is not a cost-effective means to provide incentives to new projects designed to further EPA’s air quality goals; (4) many customers may see bill increases as a result of the set-aside; (5) requiring existing and future fossil-fired generators to subsidize current and future competitors is unfair; (6) the proposal is too vague about the allocation of set-aside allowances to be adopted; (7) EPA has overstated the level of participation which can reasonably be assumed in the set-aside pool; (8) record keeping obligations will deter participation; and (9) EPA’s guidance projects outrageously ambitious growth of non-hydro renewable supply resources. If IDEM disagrees, however, and chooses to establish an energy efficiency and renewables set-aside, the allowances to fund that set-aside should not be taken from the electricity generating unit budget because doing so would unfairly lower the already stringent emissions rate to which electricity generators are subject, thereby increasing costs above what was considered “highly cost-effective” (and therefore required) in the final SIP call.

III. Opt-Ins

EPA’s model rule contains an optional section, Subpart I, which can be adopted if a State chooses to allow non-subject sources to “opt-in” to the NO_x budget trading program.⁴ To be approvable, the SIP must adopt EPA’s opt-in provisions; the State is not free to develop its own opt-in program. To be eligible to opt-in, a source must: (1) have an authorized account representative who can buy, sell or trade allowances and certify compliance on behalf of all of the owners and operators of the source; and (2) be able to monitor its emissions in accordance with Part 96, Subpart H (*i.e.*, is able to monitor emissions with sufficient accuracy to ensure that the integrity of the program is maintained). In that regard, opt-in sources (as well as other sources subject to the trading rule) generally will be required to install and operate CEMs.

In general, the broader the coverage of the trading program, the more likely it is that a viable market will develop. That is, there will be more sources with potential opportunities to reduce emissions, generating allowances for sale. State Line Energy therefore supports development of as broad-based a trading program as possible. Accordingly, we believe that inclusion of an opt-in program can provide significant benefits for the market. Specifically, an opt-in program can expand the scope of program coverage, thus enhancing market viability by increasing the number of market participants. In addition, sources generally will

4 If a State allows opt-ins, its budget for purposes of the trading program will be revised to reflect the opt-in source’s emissions.

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opt-in to the program because they plan to reduce emissions and generate allowances for sale; there would be little benefit to opting in if a source were simply going to comply on a source-specific basis, or if a source would not have sufficient allowances to comply. Thus, an opt-in program not only increases the number of market participants; it increases the number of *active* market participants. We therefore believe that inclusion of an opt-in program for sources that currently are not in the NO_x Budget Trading Program would be beneficial for promoting a viable market in Indiana.

State Line Energy appreciates this opportunity to comment on this rulemaking. If you have any questions regarding our comments, please Bob LaPlaca at (219) 473-6471.

Sincerely,

Steve Owen
Director, Midwest Business Units